Testimony on "Fixing the Watchdog: Legislative Proposals to Improve and Enhance the Securities and Exchange Commission"

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Chairman Bachus, Ranking Member Frank, Members of the Committee:

Thank you for the opportunity to discuss the organizational assessment of the Securities and Exchange Commission recently performed by the Boston Consulting Group, Inc. (BCG)[2]. The study was mandated by Section 967 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). My testimony will discuss the specifics of the BCG report and our plans for following up on the report's many recommendations, and also briefly discuss the two pieces of legislation included in the Committee's invitation letter concerning the SEC's organization and method of promulgating rules and issuing orders.

When I arrived at the SEC two years ago, the agency was reeling from a variety of economic events and mission failures that had severely harmed the ability of the agency to achieve its mission of protecting investors, maintaining fair and orderly markets, and facilitating capital formation. Reform was needed across the agency, and we immediately initiated decisive and comprehensive steps to reform the way the Commission operates. We brought in new leadership and senior management in virtually every office (including the Commission's first

[1] The views expressed in this testimony are those of the Chairman of the Securities and Exchange Commission and do not necessarily represent the views of the full Commission.
[2] On March 10, 2011, BCG submitted to the SEC and to the Congress its Report, *U.S. Securities and Exchange Commission: Organizational Study and Reform*. The report is available to the public at www.sec.gov/news/studies/2011/967study.pdf.

Chief Operating Officer and Chief Compliance Officer), revitalized and restructured our enforcement and examination operations, revamped our handling of tips and complaints, took steps to break down internal silos and create a culture of collaboration, improved our risk assessment capabilities, recruited more staff with specialized expertise and real world experience, expanded our training, and, through rulemaking and leveraging of public accounting firms' efforts, enhanced safeguards for investors' assets, among other things. Our goal throughout these many changes has been to create a more vigilant, agile and responsive organization to perform the critical mission of the agency.

It is clear our efforts are paying dividends. Last fiscal year, the SEC returned $2.2 billion to harmed investors, twice the agency's budget for that year. Similarly, last fiscal year, $2.8 billion in disgorgement and penalties was ordered in SEC enforcement actions, a 176 percent increase over the amounts ordered in fiscal year (FY) 2008. Our enforcement actions have ranged from complex cases against parties that played significant roles in the recent economic crisis to lesser known cases involving real harm to individual investors. Indeed, in each of the past two fiscal years we have filed more than twice as many Ponzi cases as the agency filed in fiscal 2008. Our examiners and enforcement investigators now collaborate frequently and effectively, resulting in a number of recent enforcement actions generated from examination referrals.

Although we have made significant progress in reforming the Commission, we continue to seek ways to improve our operations. Section 967 of the Dodd-Frank Act directed the agency to engage the services of an independent consultant to study a number of specific areas of SEC operations. The agency retained BCG to perform this role.

The BCG study provides an opportunity to re-examine and improve the SEC's operations. One of the benefits of the BCG study has been the opportunity for the agency to examine important first-order questions such as:

- How should SEC internal structure and operations be organized to permit the agency to most efficiently and productively carry out its work?

- How can the SEC maintain the right level and mix of resources, staff, and skills to successfully fulfil its statutory responsibilities?

- How can the SEC operate more strategically to identify, stay abreast of, and respond to technological developments and changes in the external environment that impact the agency's mission?

- How should the SEC best calibrate its reliance on and oversight of self-regulatory organizations (SROs) to promote effective and sound governance of the securities markets and its participants?

As can be seen in the Commission's first *Report on the Implementation of SEC Organization Reform Recommendations* transmitted to Congress earlier this week, we have developed the necessary program management and oversight infrastructure to address the next step in the agency's on-going multi-year change initiative. The staff is conducting a thorough analysis of each recommendation and designing appropriate approaches for those recommendations selected for implementation. We expect our next report, in six months, will describe the significant work done within each work-stream to analyze the BCG recommendations and recommend what, if any, actions should be taken.

The SEC's Mission in a Changing Environment

Over the past two decades, the markets, products, and participants that the SEC oversees and regulates have undergone a truly sweeping transformation. The changes since I was first a SEC Commissioner in the early 1990's until I returned as Chairman include such notable and far-reaching developments as:

- Major technological change and automation;
- Significant growth in the number of investors and in securities trading volume;
- Demutualization of exchanges and a tremendous growth in new trading platforms and centers;
- Increasing complexity of trading practices and products being traded;
- Growing interconnectedness of U.S. securities markets to other capital markets; and
- The ongoing evolution of the business models relating to broker-dealers and investment advisers.

As a result of these many changes, the SEC's job in executing its mission in today's complex and dynamic market environment is extraordinarily broad and challenging. We are responsible for examining more than 11,000 investment advisers whose assets under management total $43 trillion, over 5,000 broker-dealers with in excess of 160,000 branch offices, and 7,500 mutual funds. We also are responsible for the review of the disclosures and financial statements of nearly 10,000 public companies, including tens of thousands of disclosure documents each year, plus initial public offering and other public capital markets transaction filings of corporate issuers, public asset-backed securities offering documents, proxy statements, and filings related to public mergers, acquisitions and tender offers. The SEC also oversees approximately 500 transfer agents, 15 national securities exchanges, 10 nationally recognized statistical ratings organizations (NRSROs), 9 clearing agencies, as well as the Public Company

Accounting Oversight Board (PCAOB), Financial Industry Regulatory Authority (FINRA), Municipal Securities Rulemaking Board (MSRB), and other SROs.

In addition to these existing responsibilities, the Dodd-Frank Act significantly expanded the SEC's mission to include new duties with respect to regulation of over-the-counter derivatives and advisers to hedge funds, expanded oversight of credit rating agencies, greater disclosure regarding asset-backed securities, and strengthened corporate governance. In order to effectively supervise the changing financial markets and to implement our new responsibilities, the SEC must carefully examine its operations and processes to maximize efficiency and effectiveness. The BCG assessment provides useful guidance and structure for that effort.

The Boston Consulting Group's Assessment of SEC Organization and Operations

Last fall, the SEC engaged the services of BCG, a top-tier organizational consulting firm with significant capital markets expertise, to conduct a broad and independent assessment of SEC organization and operations. The SEC retained BCG for the express purpose of carrying out the assessment required by Section 967 of the Dodd-Frank Act, which required an independent assessment of the SEC's internal operations, structure, funding, and need for comprehensive reform, and the agency's relationship with SROs. Specific topics of study also included: the possible elimination of lower priority or redundant units at the SEC; improvement of internal communications and organizational chain-of-command; the effect of new market technologies such as high-frequency trading; hiring authorities and personnel practices; and oversight and reliance on SROs.

BCG was selected to conduct the assessment following a competitive acquisition process conducted in accordance with government procurement regulations and overseen by the SEC's Office of Acquisitions. The formal solicitation requesting quotations was made available to more than 1,500 government contractors who offer consulting services at rates that the General Services Administration had already determined to be fair and reasonable. Interested bidders were permitted more than three weeks to prepare and submit quotes, and this competition resulted in a contract award to BCG on October 15, 2010, within the 90-day deadline specified by Congress in the Dodd-Frank Act.

To perform its assessment and formulate its recommendations, BCG engaged in significant interaction with SEC staff, generally through interviews, to understand the existing state of the agency's operations. The agency actively encouraged staff to participate fully and candidly in interviews with BCG throughout the course of the engagement. Over the duration of the project, BCG conducted more than 300 interviews and meetings with agency employees, including myself, the Commissioners, division and office directors, and significant numbers of other agency staff. BCG set the agenda for these discussions to obtain insights into program operations, learn staff views, validate facts, test hypotheses, and otherwise acquire the knowledge necessary to successfully perform its work. In conducting its work, BCG also interviewed or met with a significant number of external stakeholders, including congressional offices, self-regulatory organizations, and entities that are regulated by or have significant interactions with the SEC.

On March 10, 2011, BCG delivered the results of its assessment to the SEC and to Congress in a 263-page final report titled *U.S. Securities and Exchange Commission: Organizational Study and Reform*. The final report, which was submitted within the 150-day deadline specified in Section 967 of the Dodd-Frank Act, reflects BCG's own independent findings and conclusions. I understand that at various points, BCG requested comments from many of us at the SEC; however, BCG always maintained full and complete control of their report, findings and recommendations.

BCG's Findings and Recommendations

The BCG study provides an opportunity for an independent look at SEC operations and to seek ways to improve how we accomplish our mission. BCG's assessment that progress has been made over the past two years to improve the effectiveness of SEC operations is gratifying. In particular, the report highlights, among other reforms, the work that has been done with respect to the reorganizations of Enforcement and OCIE, the rollout of the new Tips, Complaints, and Referrals technologies and program, and the hiring of a new Chief Operating Officer and Chief Information Officer. BCG in its report concurred that these initiatives were necessary and are proving effective.

While much progress has been accomplished, BCG concluded that the SEC still has "significant opportunities to further optimize its available resources." In other words, we have more work to do, and we agree that the need for improvement is a continuous one. BCG identifies sixteen specific initiatives that it recommends the SEC pursue to improve efficiency and effectiveness of operations. BCG classifies the recommendations into four categories:

1. Reprioritizing regulatory activities. Acknowledging that the SEC is making—and will continue to need to make—difficult tradeoffs in allocating resources to highest priority needs, the report recommends that the SEC engage in a rigorous assessment to better prioritize its needs and reallocate resources accordingly. This follow-on assessment is intended to help classify activities into different categories: high-priority activities that should be strengthened; low-priority activities that the SEC could scale back or stop; activities where the SEC could consider delegating responsibilities externally (such as to SROs); and mandated activities where SEC management could request implementation flexibility.

2. Reshaping the organization. The report recommends four initiatives by which the SEC can reshape its organizational structure, roles, and governance to maximize efficiency, effectiveness, and collaboration, and to drive continuous improvement. These initiatives are to: (1) systematically redesign the organization through a disciplined review of each division and offices' roles, accountabilities, and decision rights; (2) seek flexibility from Congress on the structure of certain new offices mandated by the Dodd-Frank Act; (3) review the authorities that the Commission has delegated to the staff and the processes by which the Commission and staff interact; and (4) implement a continuous improvement program to identify opportunities for reducing costs throughout the agency.

3. Investing in enabling infrastructure. The report concludes that significant new investment is needed in the SEC's key enabling infrastructure, specifically technology, human resources, risk management, and high-priority staff skills. The report recommends eight initiatives to: (1) enhance or develop key information technology systems; (2) transform the Office of Information Technology; (3) establish a Technology Center of Excellence; (4) reorganize the Office of Human Resources; (5) complete the roll-out of a new employee performance management system; (6) create a "surge capacity" plan to enable the agency to better navigate unanticipated short-term increases in workload; (7) enhance risk management capabilities in line organizations; and (8) hire more staff with high-priority skills.

4. Enhancing engagement with SROs. The report concludes that the SEC can improve both its oversight of SROs and its engagement with SROs. The report recommends three initiatives to: (1) strengthen oversight of SROs through enhanced disclosures about regulatory activities, develop metrics and standards to measure performance, and enhance oversight of FINRA; (2) centralize and coordinate the agency's interactions with SROs and foster greater dialogue with SROs on market trends; and (3) institute clearer processes for reviewing SRO rule proposals.

The report suggests that these recommended initiatives—particularly the initiative to systematically redesign the organization through a disciplined review of each office—will result in the identification of a number of staff who can be reallocated to work on higher-priority activities. But even assuming the reallocation of such staff through the organizational redesign initiative, BCG still concludes that the SEC will not have the personnel resources to perform all of the activities that are within the agency's responsibility. BCG estimates that there is currently a net staffing "capacity gap" of at least 435 to 485 full-time equivalent (FTE) positions in just the SEC's five divisions, exam program, and Office of Information Technology (OIT). BCG projects that this capacity gap will grow to at least 585 to 635 FTEs by FY 2013 as the result of expanded Dodd-Frank responsibilities.[3]

BCG also concludes that insufficient resources have contributed to a gap in the SEC's ability to develop needed information technology systems. BCG identifies specific shortcomings with respect to the SEC's budget and strategic investments in IT systems used for data analysis, data management, knowledge management, and workflow capabilities. BCG estimates that the SEC will initially require an additional \$21 to \$28 million for needed IT system improvements, with additional ongoing costs estimated at \$5 to \$7 million a year.[4]

Finally, Section 967 of the Dodd-Frank Act also directed BCG to provide legislative recommendations to the Congress, if appropriate. To this end, while the BCG report indicates that the SEC can optimize its resources through its recommended initiatives, it also suggests that the Congress should consider more fundamental "choices," such as whether to relax funding constraints to allow the SEC to better fulfill its current role or to change the SEC's statutory role

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[3] BCG presents "net" capacity gap figures that assume that any surplus staff identified as the result of the organizational redesign initiative will be reallocated to higher-priority uses. BCG did not calculate a net capacity gap for the whole agency, but calculated these numbers only for certain large SEC offices. For FY 2011, BCG estimates the net capacity gap to include 60 FTEs in OIT and 375 to 425 FTEs in the five divisions and the national exam program (p. 55). By FY 2013, the gap for the five divisions and the national exam program will grow to 585 to 635 FTEs (see p. 198, Exhibit 7.2.3.3-1, "Capacity Gap for SEC Divisions and OCIE, 2010-2013").

[4] <u>See</u> pp. 110-11 of the BCG Report.

to fit available funding.[5] Additionally, the BCG report identifies several statutory constraints that add costs or inefficiency to agency operations. For instance, BCG identifies provisions in the Dodd-Frank Act that it believes create excess organizational complexity and resource fragmentation in connection with the new Offices of Credit Rating Agencies, Investor Advocate, Minority and Women Inclusion, and Municipal Securities.

Challenges

The BCG report has provided the SEC with useful insights into how the SEC might continue its efforts to ensure a vigilant, agile, and responsive organization. Given the broad scope of the BCG report's recommendations—which touch on virtually every aspect of the agency's operations and offices—determining the appropriate course of action to take in response and implementing those actions will require careful internal coordination and a significant commitment of staff and other resources.

A critical challenge facing SEC management is determining how best to stage follow-up work in the current resource-constrained environment, especially when additional work is dictated by Dodd-Frank Act deadlines. While BCG believes that its recommended initiatives will lead to efficiencies over the long-term, the report acknowledges that substantial up-front costs are required to implement the recommendations. BCG estimates that <u>$42 million to $55 million</u> will be required over approximately the next two years,[6] in addition to the costs associated with the significant commitment of SEC management and staff time. While some

[5] <u>See</u> pp. 75-77 and 147-52 of the BCG Report (discussing choices discussed in detail).
[6] BCG's estimated implementation costs consist of a $7 to $10 million investment within the first six to nine months (Wave 1), followed by an additional $35 to $45 million over the subsequent 12 to 18 months (Waves 2 and 3). See p. 143-144 of the BCG Report.

portion of these costs can be paid for through efficiency gains outlined in the report, those savings will not be sufficient to cover the full amount.

While resources are constrained in the current fiscal year, we have nonetheless allocated some funding to support a new Program Management Office to manage the logistics of following up on the BCG report. In addition, we are using current year funding to begin work on some of the critical IT priorities that BCG identifies in its report.

Because resources do not permit us to implement all the recommendations at once, our follow-up process has been focused on thinking strategically and prioritizing the various initiatives. For those initiatives that we can begin to implement now, we are working to develop realistic and achievable implementation plans and schedules for implementation. We are also carefully assessing how to move quickly while also ensuring there is sufficient time to communicate with, and give consideration to the views of, key stakeholders. Last but not least, we also are assessing how best to make use of management and staff time and to determine what pace of change the agency as a whole, or any particular office, can successfully absorb.

Progress to Date and Next Steps

In the months since the report was released, the SEC has made progress to establish processes and infrastructure to analyze the BCG study recommendations. Immediately following the issuance of the report, I designated our Chief Operating Officer, Jeff Heslop, to manage the logistics of the follow-up process. The agency has divided the BCG recommendations into approximately seventeen discrete work-streams, each assigned to a division or office director or other senior executive. We have designated this initiative as the SEC Mission Advancement Program (MAP) and have organized the work-streams around four principal goals: optimizing the agency's mission and structure; strengthening capabilities; improving controls and efficiencies; and enhancing the workforce.

The SEC has set up several "governance" mechanisms to ensure accountability and timeliness of our follow-up efforts. An effective governance structure is especially important because successful implementation of some of the recommendations appears likely to require a sustained effort over several years. As noted above, we have established a dedicated Program Management Office within the Office of the Chief Operating Officer (OCOO) as recommended by BCG to be responsible for tracking the agency's implementation efforts. We also have established an Executive Steering Committee—which is meeting regularly—to review implementation plans and advise on how best to prioritize, sequence, and harmonize the significant follow-up work resulting from the two dozen work-streams.

The next three to six months will be primarily focused on analysis of the way forward. Significant work has already been done within each work-stream to analyze the BCG recommendation and recommend what, if any, actions should be taken. In the near term, the agency's focus will be on assessing the schedule, costs, and management bandwidth required for each initiative, identifying cross-work-stream integration points, and developing a detailed prioritization and implementation plan that harmonizes and sequences all the various follow-up activities. Because many of the recommendations also touch on issues that affect the SEC's workforce, including those which are covered by the SEC's Collective Bargaining Agreement with the National Treasury Employees Union (NTEU) our follow-up efforts in certain cases will entail engagement with the NTEU.

While much work is still underway, the agency has already begun to implement a number of BCG recommendations. For instance:

- Clarifying and empowering the Chief Operating Officer. As part of its recommendation that the SEC redesign its organizational structure, BCG concluded that the SEC could simplify the support office structure by consolidating the Office of the COO and the Office of the Executive Director (OED) into one office. I agreed with this recommendation and we have implemented it.

- Building high-priority staff skills. BCG's report identifies several areas where the SEC would benefit from increasing capacity, building new organizational capabilities, and improving individual competencies. Because of funding constraints, BCG recommended that the SEC build high-priority skills by filling vacancies caused by attrition with employees who meet these needs. Consistent with this recommendation, we have focused hiring in FY 2011 on developing needed skills, including specialized industry expertise in such areas as over-the-counter derivatives.

- Establishing a Continuous Improvement Program. BCG's report recommends that the agency undertake an initiative to systematically reduce unnecessary costs throughout the organization. To accomplish this, the COO has established a Continuous Improvement Program to identify opportunities for cost savings and efficiencies in agency programs and operations, such as through streamlining of business processes.

- Improving the Office of Administrative Services (OAS). Consistent with BCG's recommendation to systematically redesign the organization, the SEC has recently launched a major initiative to improve operations within OAS, which is responsible for overseeing a number of key agency support functions, such as contracting and procurement, managing the agency's facilities and assets, mail distribution, printing, and office supplies. In July, I announced that the agency was working to improve efficiency and controls by asking the General Services Administration to manage the agency's real property leasing program going forward. We have also launched a comprehensive assessment of OAS operations, including its organizational structure, decision-making processes, reporting relationships, and quality controls. Through this initiative, we also hope to identify opportunities to improve operations, including efficiency, cost reduction, and internal controls. This assessment is expected to be completed in November 2011, and any restructuring and improvements will be implemented thereafter.

- Optimizing the organizational design of the Office of Information Technology (OIT). BCG noted that, under the leadership of our new Chief Information Officer, Tom Bayer, who joined the SEC in October 2010, "The SEC's recent momentum with regard to technology is promising." As part of its recommendation that the SEC enhance OIT's ability to deliver technology solutions, BCG suggested that OIT adopt an organization design that emphasizes increased alignment with internal clients, improved coordination with IT groups located within the program offices, and increased efficiencies by centralizing activities such as application development and project management. Since the report was issued, OIT has moved forward to overhaul its organizational design consistent with these principles.

- Redesigning the Office of Human Resources (OHR). As part of its recommendation that the SEC invest in key enabling infrastructure, BCG suggested that the SEC complete its redesign of OHR to improve personnel management. The report noted that "the SEC has taken a number of important steps to improve OHR," including "considerable progress in improving its training function." The SEC is presently at work to complete a restructuring of OHR, including to embed HR experts within the agency's operating divisions; more clearly define OHR's administration, client relation, and center of expertise functions; expand and centralize the SEC's training programs; and streamline the recruitment process. Additionally, the SEC is also moving forward with BCG's recommendation to implement a new performance management system, and is presently conducting extensive training for staff to assist with the transition to the new system.

Legislation

The Committee attached two pieces of legislation to its hearing invitation letter. The first, the SEC Modernization Act of 2011, would significantly restructure the SEC by, among other things, reducing the number of SEC's divisions, restructuring the Office of the Chairman, and modifying certain new offices created by the Dodd-Frank Act. As my testimony describes above, we are actively reviewing some similar recommendations from the BCG study to evaluate improvements in the structure, operations and processes of the agency. While I agree with several of the approaches proposed by this legislation, there are provisions of the bill that would cause me real concern. While I have a number of concerns, first and foremost, I would be very concerned about the overarching loss of the agency's flexibility in the future to change with our dynamic capital markets if its structure is rigidly established by statute. I would welcome an opportunity to work with the Committee on this legislation.

The second bill attached to the invitation letter is H.R. 2308, the "SEC Regulatory Accountability Act." The bill would establish a significant number of additional specific standards for cost-benefit analyses for Commission rules and orders. As you know, statutory requirements already explicitly require the Commission to consider the economic effects of its rules, and economic and cost-benefit analyses are fundamental components of the Commission's rulemaking process and an essential part of our work.

The bill enumerates eleven new factors for the SEC to consider in its economic analysis, each of which would create a new potential challenge to future rules. Moreover, a number of these new factors are potentially in conflict with the SEC's mission, duplicative of existing requirements, unrelated to SEC rulemaking, or unclear in scope. For example, the bill's direction to "assess the best ways of protecting market participants" could conflict with the SEC's mission. The SEC's mission is to protect *investors*, which in some cases means protecting them *from* certain market participants.

Additionally, while clear statutory statements of components of cost benefit analyses provide useful direction, those standards should apply similarly to all federal financial regulators and must be consistent with our mission. The requirements under this bill would be more extensive and more onerous than the requirements placed on other agencies. The bill would apply not only to rules, but also to orders, which could significantly impede the SEC's ability to administer the securities laws. Requiring cost-benefit analyses for orders could undermine our ability to issue enforcement orders against wrongdoers, delay exemptive orders needed to facilitate the introduction of new investment products to the market, and impede the capital formation process by delaying orders to registrants that accelerate the registration of their securities.

Concern about the appropriate balance between costs and benefits of rules is a very valid consideration in rulemaking. However, any statutory requirements should provide clear direction and include achievable standards. Otherwise, the result will be a rulemaking process that is incapable of implementing Congress' statutory directions and is consistently subject to challenge.

Conclusion

The SEC recognizes that implementation of many of the ideas in the BCG report will require a long-term commitment and sustained effort over several years to successfully implement. While we are still in the early stages of implementing the BCG recommendations, the SEC is committed to an open and transparent process. The SEC is also prepared to assist Congress should legislative action be required to implement the ideas discussed in the BCG report.

Thank you again for the opportunity to testify today. I am happy to answer any questions that you might have.